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Estate Planning

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ESTATE PLANNING

MILTON ELROD, JR.*

Estate planning which concerns itself in a very large part with estate tax problems, constitutes the phase of tax law which in my own humble opinion attorneys generally have been least ready to recognize. And it strikes me that this may have resulted from the fact that the average attorney has failed to see, in the estate planning field, any substantial opportunity to "increase the sphere of his professional activities." The facts of the matter are exactly to the contrary as I hope to be able to establish in the course of these remarks.

Many of you may feel that the problems of inheritance and estate taxation are problems which are too remote and inconsequential for the average everyday client to worry about. Many men, certainly many of my insurance friends, and apparently many attorneys, do seem to feel that this type of problem is confined to the "malefactors of great wealth" of Roosevelt I and the "economic royalists" of Roosevelt II.

In fact we seem to have a big city, big firm complex in this connection, believing that these estate planning and estate tax problems concern only the ultra-wealthy clients of the ultra-large law firm in the metropolitan area, and do not concern our own everyday clients in our own everyday Richmond, or Evansville or Kokomo, or even Indianapolis. Many times in the past year I have been asked in effect, by well-meaning and sincere friends in the profession, "But, Milt, are there enough large estates, enough people with enough wealth in Indianapolis to sustain a practice confined to the estate planning field?"

The very question itself is indicative of the general feeling that these cases are isolated, exceptional, and highly uncommon. But these death tax problems, in simple but none the less important form, really go a lot deeper into a lot smaller estates than most of us think.

It seems to me that the heavy publicity given to the tax burdens in the very large estate tends to disrupt our thinking in this matter. We read in the papers and in various services about the dramatic tax problems of the large estate. And

* of the Indianapolis Bar.

we hear so little about the less news-worthy examples of hundreds of smaller estates. Then, too, the common association of estate planning and inheritance tax problems with living gifts, complex trust arrangements, and other complicated procedures for avoiding transfer costs tends to confuse our thinking. We seem to feel that unless the problem is so acute that some elaborate tax procedure is in order, we seem to conclude that there is no problem. So many of us seem to fail to realize the tremendous increases in inheritance and estate tax costs in recent years.

We are quite familiar with income tax problems and the burdensome levies that are currently being imposed because we have to deal with those problems today, both for ourselves and our clients. But we don't seem so aware of the estate tax situation.

The fact of the matter is that today's federal estate tax liabilities are three and four times as great as those faced in estates of comparable size barely ten years ago.

I can illustrate that with a very few examples, enough to indicate the possibilities. Taking net estates after deductions, but before exemptions, a \$100,000 net estate, ten years ago, paid a federal estate tax of \$1500. Today that tax is \$4800. If you double it to a \$200,000 net estate before exemption, the tax was \$8300, and the Federal Estate tax, today is \$31,500. If you take it to a \$300,000 net estate, than \$15,900, today \$59,100.

Now, these increases in tax liabilities have resulted in part from substantial increases in the federal estate tax rates, of course, and in part from a reduction, a continuing reduction, in the federal estate tax exemption.

If we should take a net estate of \$160,000 which is not a terrifically large estate, including \$40,000 of life insurance in that estate, we find that back in 1928 \$140,000 of that estate would have been exempt and only \$20,000 taxable.

In 1932 \$90,000 was exempt and \$70,000 taxable. Today \$60,000 is exempt and \$100,000 taxable, the situation having almost reversed itself.

The present federal estate tax exemption of \$60,000 may seem, at first, quite sufficient to eliminate this problem for a substantial majority of your clientele. Perhaps, this is true, particularly if one thinks in terms of the estate which will be subject to probate, which, of course, is the

estate with which we as lawyers are commonly concerned. But it is, of course, a fact that many types of property which are not part of the estate for probate purposes *are* part of the estate for federal estate tax purposes.

For one example, property held in joint title with another person with right of survivorship, yes, even property held in a tenancy by the entirety by the husband and wife, will be part of the husband's estate for federal estate tax purposes if the husband furnished the funds which purchased the property, which is usually the case. This point is mentioned with a definite and specific motive in mind.

During the course of my work as editor for the Insurance Research and Review Service of this city, hardly a week would pass but what we would receive a letter from some one of our subscribers or service members to the general effect that our tax material stated that jointly owned property was taxable where the deceased put up the purchase price, and that some policyholder or client had consulted his attorney and had been informed that such property was not part of the estate and could not be subjected to federal estate tax.

I am informed, by Mr. Hilgedag of that organization, that these letters continue to arrive with disturbing regularity. It seems clear that many lawyers are even today under the impression that jointly owned property passing under an automatic right of survivorship such as a tenancy by the entirety is not taxable in the estate of a deceased joint owner, although the tax rule in this connection has been thoroughly established for many years and by a long line of Supreme Court decisions.

Another example of property not ordinarily considered part of the estate, but which is still taxable for federal estate tax purposes, is life insurance payable to named beneficiaries. Such insurance is exempt from Indiana Inheritance Tax but is none-the-less part of the estate for federal estate tax purposes if the insured *either* owns any of the so-called legal incidents of ownership in the policy *or* if the insured paid the premiums on the policy up to the time of death. There are, you see, two criteria for determining the taxability of life insurance proceeds under the federal estate tax law. The insurance is taxable if the insured owns and controls the policy, regardless of who pays the premiums. The insurance

is likewise taxable if the insured paid all of the premiums directly or indirectly, regardless of whether or not the insured has any ownership rights in the policy at the time of his death.

An insured who presently owns a policy of insurance on his life, and who has paid and continues to pay the premiums on that policy, finds himself in the position of being unable to take the proceeds of that policy out of his estate even though he gives the policy away absolutely and unqualifiedly by an absolute and unconditional assignment.

Only recently my attention was called to a situation where an attorney had advised an insured that it was only necessary for the insured to assign a policy to his wife to take it out of his estate for federal estate tax purposes, notwithstanding the fact that the insured had paid all the premiums on this policy since 1917 and would necessarily continue premium payments because the wife was without funds for that purpose. Unfortunately, the assignment of that policy under those conditions and under our present law would not have avoided one penny of the estate tax liability.

In fact, under present rules, about the only life insurance which *will* be exempt from federal estate tax is insurance which was purchased and owned by the beneficiary and on which the beneficiary paid all of the premiums out of his or her own independent income and resources. In short, unless the policy is owned by the beneficiary, and all premiums were paid by the beneficiary, and all premiums were paid by the beneficiary out of funds which were clearly the beneficiary's own funds, and were not derived from the insured himself by way of gift or other indirect transaction, the proceeds will be taxable in the estate of the insured. There are, of course, exceptions; but such is the general rule.

Then, too, there is property which the deceased during his lifetime placed in revocable, or even irrevocable trusts. Such property would not normally be part of his estate for probate purposes, but it *will* be part of his estate for federal estate tax purposes if the trust is revocable, and even if the trust is *irrevocable* if the deceased grantor retained any income rights in the trust estate, or retained any substantial measure of control over the property during his lifetime, or retained any right to direct the distribution of trust income or trust principal at his death, or even if he retained

the right to have the trust estate revert to him if the trust beneficiaries should predecease him.

Then there is the item of government securities, particularly the so-called "Baby Bonds," or "Defense Bonds," or "War Bonds." Even postmasters selling these securities have been known repeatedly to make erroneous statements concerning their estate tax position; and only last week I was charged with error by a local attorney because of my statement that the substantial block of War Bonds owned by a client would be taxable in his estate. My colleague insisted that such bonds were exempt from taxation including estate taxation; but unfortunately such is not the case. Even where the bond is held in joint ownership, or where it is payable to a designated death beneficiary, and hence is not part of the estate subject to probate, it is still included in the gross estate for purposes of the federal estate tax law. The statement in many government bonds that they are exempt from all taxation does NOT exempt them from estate tax, and in many cases does not even provide an exemption from federal income tax. This fact has been clearly established, but still seems the subject of much confusion and misunderstanding.

Another illustration of the point is Annuity Refunds Benefits, payable to some individual at the death of the annuitant under an annuity contract which pass at death by contractual right and is not subject to probate, but is still taxable in the estate of the deceased annuitant for estate tax purposes.

War Risk insurance, the government life insurance issued during the last World War, as well as the National Service Life Insurance currently being purchased by members of our armed forces, is also taxable in the estate of the deceased, notwithstanding express provisions in the policies exempting such insurance from taxation. The United States Supreme Court so ruled in *United States Trust Company v. Helvering*, 59 S. Ct. 692.

You see, both the layman and the attorney are inclined to approach these tax questions from the standpoint of normal legal concepts and rules, and tend to think of their estates in terms of the property legally subject to probate and passing under the will or laws of descent. It is, of course, particularly difficult for the lawyer to shift from his normal

thinking in terms of legal title and legal rights to a field where economic benefits and practical results are far more significant. In his ordinary transactions with his client, the lawyer is concerned primarily with the legal title and rights involved in the contract or deed or whatever it may be, and only secondarily concerned with the economic results of the transaction. In tax matters, it is necessary to reverse the emphasis. And this reversal is rendered doubly difficult by virtue of the fact that even in the field of tax law, the emphasis on economic benefits as distinguished from legal rights is a relatively recent development, coming in a large part as the result of Supreme Court decisions in the last two and three years.

A most interesting illustration of this came to my attention only a few days ago. In cleaning out some old files of legal articles, I found an article by two members of the New York Bar on "Minimizing Income and Estate Taxes With the Family Trust." It appeared in the Brooklyn Law Review in May, 1936, something less than six years ago, and in that article the following quotation appeared:

"Ever since the enactment of the federal income and estate taxes, the trust device has been a favorite for the avoidance of taxation. The legal theory underlying this technique is grounded upon the long accepted view that upon the creation of a trust the settlor, unless he specifically reserved the rights to himself, surrenders all legal interest in the trust property and trust income; the equitable interest passes to the trust beneficiary and the legal title to the trustees. And even if the grantor should nominate himself as trustee and give himself by the terms of the trust instrument broad administrative powers, nevertheless, according to trust theory, the property is no longer his."

That, of course, is fundamental law that we all know. But, bearing in mind that last sentence, I beg leave to quote from the ruling of the United States Supreme Court in the recent decision of *Helvering v. Clifford*, handed down February 26, 1941 (three years ago next month) in which Justice Douglas, speaking for the majority of the court, had the following to say:

"In this cases . . . the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent (grantor), all lead irresistibly to the conclusion that respondent continued to be the

owner for purposes of Section 22 (a) . . . The wide powers which he retained included for all practical purposes most of the control which he as an individual would have If it be said that such control is the type of dominion exercised by ANY trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family, and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position . . .

"For, as a result of the terms of the trust and the intimacy of the family relationship, respondent (grantor) retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered . . . (But) to hold otherwise would be to treat the wife as a complete stranger, to let mere formalism obscure the normal consequences of family solidarity, and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements."

The "legal niceties" referred to by Justice Douglas are

- (1) the separate legal identity of husband and wife, and
- (2) the legal distinction between individual ownership and ownership by the same person as trustee for another.

When we consider ALL of the property that must be considered for tax purposes, and when we think in terms of present day tax liabilities and exemptions and rates, we are very likely to find that a surprising number of your clients today are in a taxable estate bracket and face a very real problem from the standpoint of meeting the total estate liabilities and costs that will be faced. You can drive around Indianapolis, or your own home town, and see any number of homes or farms, literally hundreds of them, worth \$15,000 to \$20,000; and the occupant of one of those homes or the owner of one of those farms (even if it is in joint title with his wife), possessing even a modest life insurance estate involving a few thousand dollars of proceeds at his death, and possessing even a modest accumulation of War Bonds or other property, needs very little miscellaneous estate indeed to boost him into an estate tax problem.

Particularly is this true of almost any such individual who owns an interest in a business enterprise of some sort, a partnership or a close corporation or a sole proprietorship enterprise. When such a business is given a reasonable val-

uation for estate tax purposes, and is included with the home and a decent life insurance program, an estate tax problem almost invariably appears. And remember that many such business enterprises will possess an unexpectedly high valuation for estate tax purposes on the basis of capitalizing current earnings—because of currently high profits due to war business of one kind or another. In this town, as in your own communities, there are many men in smaller business enterprises whose estates, for tax purposes, will total \$100,000 or \$150,000 or \$200,000, when all factors and all items are considered—men who today face a tremendous problems of forced liquidation of their estate assets at death under present conditions. You know as well as I do the type of assets ordinarily found in such estates—non-liquid real estate, close corporation stock which has no ready market, partnership or proprietorship interests, and a variety of securities or uncertain value for the most part. Out of assets of that sort, a man with a \$100,000 net taxable estate must find more than \$20,000 cash for federal estate tax purposes alone, *plus*—Indiana Inheritance Tax costs (often much larger than the federal tax in smaller estates, with only \$15,000 exempt to a widow, \$5,000 for minor children, \$2,000 for adult children, and even less for more remote heirs), *plus* administration costs and fees, *plus* burial and last illness expenses, and *plus* at least some unpaid income and property tax liabilities.

That is the very real and very acute problem faced by a very great number of men, men who are your clients, today. That is the basic problem that estate planning is designed to solve, this problem of cash estate obligations far in excess of liquid estate assets. I can illustrate that from an actual case. I took this case out of my files, and it concerns a man residing in a rural community in the northern part of this state near Auburn, Indiana. This man's estate consisted of his home, in joint title with his wife, certain real estate including two farm properties, a part interest in a funeral business, a handful of securities, and the normal cash on hand and funds in the bank, together with about \$50,000 worth of life insurance. His total estate valued between \$150,000 and \$200,000, including the life insurance. He had set aside \$3,000 of life insurance to meet his estate obligations—funeral expenses, last illness, taxes, etc.

This man's first mistake was his notion that the property he held in joint title with his wife was entirely exempt from federal estate tax. It was not. As a result his estate, at the time we examined it, was subject to about \$6,000 in federal estate taxes, instead of the nominal amount he had anticipated—*twice* the amount he had set aside to meet estate obligations.

This case developed in 1934, almost ten years ago. At that time the federal estate tax exemption was \$50,000, plus an *additional* \$40,000 for insurance to named beneficiaries. The rates were lower, and the tax then was \$6,000 as I have just stated. Today, the federal estate tax on this same estate would aggregate, in itself, more than \$26,000.

Also, while some of the estate consisted of real estate owned as tenancy by the entirety with the wife and exempt from Indiana inheritance tax, a good portion of the real estate passed to brothers and sisters with low exemptions and higher rates, so that we discovered some \$1,500 in state inheritance tax liability, instead of none at all as this man had thought. Then, too, we found some of the real estate was located in the Far West—New Mexico, I believe.

Obviously probate of the estate was going to be slower than usual and involve more than the ordinary costs in view of this situation, and we estimated some \$10,000 of probate expenses and fees, including executor and attorney fees, as a very conservative figure. Unpaid income and property taxes aggregated roughly \$1,500 a year. So we took this man's own estimate of \$3,000 for funeral and burial expenses and debts, and we added \$1,500 for unpaid income and property taxes, and we added another \$6,000 for the federal estate tax, and another \$1,500 for Indiana inheritance tax, and \$10,000 for estimated probate costs—and we discovered that this man would have to meet some \$22,000 of cash estate liabilities, under the laws in 1934.

Even at that time, this would have been no small task in view of the generally non-liquid character of his estate; but conceivably the job could have been accomplished without too serious a loss from liquidation of estate assets, although this individual felt it less expensive and more satisfactory to provide additional life insurance payable to his executor in an amount sufficient to meet all of these costs at once in cash. Today, however, this same estate would face liabilities

in excess of \$45,000—almost \$50,000 of estate obligations to be met out of \$200,000 of estate assets, almost all of which were non-liquid in character.

Here we clearly reveal the most serious and important problem from an estate planning standpoint today; and there can be little doubt but what the most important step your client can take in the way of sound estate planning and estate conservation, is to check once again in the light of today's tax laws and today's tax philosophies the cash demands that must be met in the event of death. For times change, and tax laws change; and as a result estate needs for cash change radically.

Today those needs are vastly greater than they have ever been before; and many estate plans, many wills, and many trusts are in existence which will prove to be almost wholly ineffective and inadequate because of a serious underestimation of the obligations that the estate owner will leave upon his death. A survey of literally hundreds of estate plans, made while I was editor of the Insurance Research and Review Service, revealed that most of them contained hopelessly inadequate arrangements for meeting the cash obligations which the estate would face, when proper consideration was given to the tax items that would have to be met.

The first step in any sound estate plan is the provision of adequate funds to meet potential estate liabilities and unless or until that step has been taken carefully and completely, the whole estate program, including any will that may be involved in that program as well as the settlement arrangements on any life insurance that may be in the estate, is built upon an unsound foundation that can result in the destruction of all that has been undertaken.

Obviously, if the estate obligations are underestimated, or if the estate finds it necessary to pay the transfer taxes on large amounts of life insurance and war bonds or trust properties which do not come into the hands of the executor or administrator the whole course of devolution of the estate property may be altered, and the whole structure of the will may have to be changed.

Life insurance men and trust men are constantly calling this fact to the attention of your clients. In so doing they are rendering a service to your clients, and in fact to you, be-

cause a proper consideration of this problem may well result in the preparation of new or revised legal instruments, particularly in connection with the will. But the primary responsibility for informing your clients of this situation is in truth and in fact your own. Too often the client views recommendations of the life underwriter or the trust officer with a liberal measure of suspicion, crediting the recommendations at least in part to a desire to sell additional life insurance protection or to the desire to develop new trust business. Your own counsel comes to him as the advice and recommendation of the one to whom he looks for such advice in matters of this character involving legal and tax problems. Moreover, when the insurance man or trust officer discovers the need for a change, it can only reveal your own failure to call the fact to your client's attention. In fact, today, it is almost your personal responsibility and duty to bring this situation to the attention of those of your clients whom it may concern.

That fact has been clearly established in Opinion No. 210 handed down in 1941 by the Committee on Professional Ethics of the American Bar Association from which the following quotation has been taken:

"Many events transpire between the date of making the will and the death of the testator. The legal significance of such occurrences are often of serious consequence, of which the testator may not be aware, and so the importance of calling the attention of the testator thereto is manifest.

"It is our opinion that where the lawyer, has no reason to believe that he has been supplanted by another lawyer, it is not only his right, but it might even be his duty to advise his client of any change of fact or law which might defeat the client's testamentary purpose as expressed in the will."

Time forbids more than a presentation of the basic problems and its significance to you and to your clients, so far as this particular session is concerned. I have obviously adhered to the fundamental proposition that a real problem does exist for a great many of your clients. And I can only hope that in the presentation of these fundamentals I have perhaps made you sufficiently familiar with the problem, that you will see in it the opportunity to "increase the sphere of your professional activities."

